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IN THE

Supreme Court of the United States

OCTOBER TERM, 1958

No. 637

MERCHANTS WAREHOUSE COMPANY, INC., *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

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Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Sixth Circuit entered in the above entitled case on October 24, 1958.

OPINION BELOW

The findings of fact and memorandum opinion of the Tax Court (pp. 43a-67a of Court of Appeals Appendix) are not officially reported. The opinion of the

Court of Appeals (Appendix A, *infra*, pp. 1a-8a) has not yet been officially reported.

JURISDICTION

The judgment of the Court of Appeals was entered on October 24, 1958. (Appendix A, *infra*, p. 9a). The jurisdiction of this Court is invoked under 28 U.S.C., sec. 1254.

QUESTION PRESENTED

Whether bonds of a corporate taxpayer outstanding during 1943 and 1944 may be included in borrowed capital for excess profits tax purposes only to the extent of what the Tax Court found their market value to be in 1937, when they were issued.

STATUTE INVOLVED

The statutory provisions directly involved are Sections 716 and 719 of the Internal Revenue Code of 1939, the pertinent portions of which are set forth in Appendix B, *infra*, pp. 10a-11a. For ready reference, the pertinent portions of the corresponding section of the Korean statute, Section 439(b)(1) are also set forth in the Appendix, as well as the pertinent portions of Section 711, Internal Revenue Code of 1939, to which reference will hereinafter be made.

STATEMENT

In 1937 the taxpayer issued 5 per cent income bonds and common stock in payment for real property. The bonds were in the amount of $535,000. These bonds were outstanding in 1943 and 1944. The taxpayer used the invested capital method of determining its excess profits credit. The Commissioner of Internal Revenue

determined that the bonds should be allowed only to the extent of $350,000, which was the amount for which the property had been bid in at a foreclosure sale in 1937 by a committee representing bondholders of a prior owner. The Tax Court held that the fair market value of the property in 1937 was $450,000; that petitioner's stock issued in part payment for the property had a fair market value of $75,000; that the bonds had a fair market value of $375,000; and that borrowed capital should be allowed only to the extent of the fair market value of the bonds. Neither party to the proceeding had made this contention prior to the Tax Court's decision. In arriving at the amount of the deficiency under the Tax Court's Rule 50, the deduction for interest under Section 711 (Appendix B, *infra*, p. 10a) was reduced by an amount equal to 50 per cent of the interest paid by petitioner on the entire bonded indebtedness,—not merely the interest paid on $375,000 of such indebtedness.* The taxpayer filed petition for review and the Court of Appeals affirmed, stating merely (in connection with the point now at issue) that it agreed with a paragraph in the Tax Court's opinion which was quoted *verbatim*.

No prior reported case under either the World War II or the Korean War excess profits tax laws has been found in which the Commissioner of Internal

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* A corporate taxpayer which uses the invested capital method must include all borrowed capital even though it bears such a high interest rate that the net effect is to the taxpayer's disadvantage. *Central Signals, Inc.*, 10 T. C. 1015, 1022, aff'd. 174 F. 2d 479 (C. A. 2, 1949). To allow borrowed capital in an amount substantially less than face amount is, of course, the equivalent of increasing the interest rate. For example, in the instant case, 5% on the face amount of $535,000 is more than 7% on the original market value of $375,000.

Revenue has contended that borrowed capital should be allowed in any amount other than the face amount of the outstanding indebtedness incurred by the taxpayer in good faith for purposes of the business. While the instant case was under consideration by the Tax Court, the District Court for the Middle District of Georgia, Macon Division, rendered a decision in *Southern Fertilizer & Chemical Co. v. Edwards, Admr.*, 44 A.F.T.R., p. 1953, decided June 23, 1955 (not officially reported, but cited in the opinion of the Court of Appeals in its quotation from the Tax Court, as ..... F. Supp. .....), in which the taxpayer *conceded* that borrowed capital consisting of bonds should be so limited *if* the Court should adopt its contention that the bonds had been issued at a discount and that it was entitled to amortize the discount over the life of the bonds, taking a deduction each year for the amount of the annual amortization in computing its net income. Having held for the taxpayer on the amortization issue (a decision we believe to be erroneous), the District Court necessarily gave effect to the taxpayer's *concession* with respect to borrowed capital. This decision is the only authority for the decision in the instant case, although undoubtedly many thousands of taxpayers have had their excess profits tax credits determined on the basis of the face amount of the indebtedness under both the World War II and Korean War excess profits tax laws. In each of the two other cases cited by the Tax Court on the point, *Tennessee, Alabama & Georgia Railway Co.*, 13 T.C. 486 (1949), aff'd. 187 F. 2d 826 (C.A. 6, 1951), and *Walsh Holyoke Steam Boiler Works, Inc.*, 5 T.C. 814 (1945), aff'd. 160 F. 2d 185 (C.A. 1, 1947), borrowed capital had been allowed at the administrative level in the face amount of the outstanding bonds, although (as in the

instant case) the bonds had originally been issued, together with stock, in payment for property having a market value less than the aggregate of the market value of the stock and the face amount of the bonds.

REASONS FOR GRANTING THE WRIT

It is believed that the Court of Appeals has decided an important question of federal law which has not been, but should be, settled by this Court.

There are undoubtedly a number of corporate taxpayers whose excess profits tax liability under the World War II excess profits tax law has not yet been settled, and many more whose tax liability under the similar provisions of the Korean War law is unsettled. If Congress should enact in the future another excess profits tax law, it is likely that the borrowed capital concept will be retained. It is thus a matter of public importance that it be determined by this Court whether the "amount" of indebtedness to be included in borrowed capital is its face amount or its market value at the time the borrowing originally takes place.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

APPENDIX A

Filed Oct. 24, 1958
CARL W. REUSS, Clerk

No. 13,352

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

MERCHANTS WAREHOUSE COMPANY, INC., *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

ON PETITION FOR REVIEW OF A DECISION OF THE TAX COURT
OF THE UNITED STATES

Decided Oct. 24, 1958

Before SIMONS, Chief Judge, MARTIN and MCALLISTER, Circuit Judges.

MARTIN, Circuit Judge. The petitioning taxpayer, Merchants Warehouse Company, Inc., was incorporated under a Tennessee charter on March 4, 1937, to purchase and operate a five-story warehouse building, known as "Cummins Station", in Nashville, Tennessee. Before the organization of the corporate taxpayer, the warehouse property had been owned by another corporation (Wholesale Merchants Warehouse Company), which had outstanding bonded indebtedness to the amount of $550,000 secured by a deed of trust on the property.

During 1934, Wholesale Merchants Warehouse defaulted in the payment of interest due on its bonds; and the trus-

tee in the deed of trust took over the property and operated it for the benefit of the bondholders. In an ensuing chancery court proceeding, the trustee was directed to foreclose under the deed of trust and an appraiser was appointed to report upon the valuation of the property. This appraiser, presumably an expert, reported that in his opinion the property had a value of $375,000.

At a foreclosure sale on February 8, 1937, a bondholders' committee, holding $535,000 of the total issue of $550,000 of Wholesale Merchants Warehouse Company bonds, bid in the warehouse property for $350,000 and the assumption of the 1937 taxes. Under the terms of the sale, the bondholders were privileged to tender in part payment of the purchase price bonds and coupons in proportion to their interest in the net proceeds resulting from the sale.

The bondholders' committee then organized the petitioner corporation to acquire the property and directed the trustee to deed the property to the new corporation. In exchange therefor, the petitioner issued to the committee for distribution to the depositing bondholders $535,000 of new fifteen-year, five percent bonds in addition to all the taxpayers' authorized stock, consisting of 535 shares of non-par common stock. Money had been accumulated from the operation of the warehouse by the trustee. A part of this money was used to pay the few non-depositing bondholders at the rate of $686.97 for each one-thousand-dollar bond. The remaining balance was paid over to the taxpayer as the new owner of the property. $5,350 of this balance was credited by the taxpayer to its capital account, giving the 535 shares issued a paid-in value of $10.00 each. The remainder of the fund was distributed *pro rata* to the depositing bondholders who received, for each bond deposited, a $1,000 bond of the petitioner, one share of its stock and $22.70 in cash.

At a meeting a few days after the incorporation of the new company, its incorporators adopted a resolution that

the warehouse property acquired had a fair market value of $600,000 and that this amount should be set up on the books of the company as the fair value of the property. Admittedly, the Cummins Station property was "almost ideally located from a distributing standpoint for interstate, suburban and local commerce." It was also excellently situated in relation to principal highways and railroads, with two private switch tracks adjacent to it, thus eliminating drayage in connection with railroad shipments.

However, the warehouse building that had been erected thirty-one years before had been badly used and was in need of repair, fresh paint and new window sills. The inside walls, heating plant, floors and some elevators were in poor condition. The gross rental had declined from a high in 1928 of $94,791.30 to a low in 1934 of $46,468.60. At the time of the sale of the property, only about eighty per cent of the floor space was rented and no tenant was obligated to a lease for a term of more than a year. At the rate of rental, had the full floor space of the building been rented throughout 1937, the annual gross rental for the warehouse would have been $62,268. In 1937, assessments on the property were for city taxes placed at a valuation of $375,000 and for state and county taxes placed at $500,000.

The court-appointed appraiser, Whitsitt, in estimating the value of the property, considered its prime location, past earnings, current rentals and reproduction costs. Economic conditions and the real estate market in Nashville improved markedly in 1937. New warehouse buildings had been constructed and rented at annual rentals of twenty-seven and twenty-eight cents per square foot of floor space as contrasted with fifteen and [illegible] cents per square foot of floor space rentals in the Cummins Station property. The ownership of most of the petitioner's bonds and stock remained in the old bondholders until September of 1943, during which time the rents were not raised and the interest on the income bonds was not paid in full.

In September, 1943, G. L. Comer, a clothing manufacturer who was one of the tenants of the warehouse company, acquired $519,000 par value of the income bonds and 519 shares of the stock of petitioner for a total consideration of $343,350. This merchant paid a $6,000 commission to a broker for services in aiding him in the acquisition of the bonds and stock. Comer considered that he had made a bargain purchase. He promptly raised the rentals; and, after he acquired control of the property, interest in full was paid on the income bonds.

In his statutory notice of deficiency, the Commissioner of Internal Revenue determined that the total cost of the land and building when petitioner made its purchase in 1937 was $350,000, of which $250,000 should be allocated to the building and $100,000 to the land; and that, for 1943 and 1944, the respective amounts of $6,307.81 and $6,459.90 represented reasonable allowances for depreciation on the building and for subsequent additions. The declared value of petitioner's capital stock as stated on its return for the fiscal year ending June 30, 1957, was $75,000. In computing its invested capital on its excess profits tax returns for 1943 and 1944, petitioner listed the amount of $5,350 as "Money paid in for stock, or as paid-in surplus, or as a contribution to capital."

Petitioner averred that the Commissioner erred in failing to include as equity invested capital for 1943 and 1944 the fair market value of the common stock which it exchanged, together with its bonds, for the warehouse property in March of 1937. Petitioner asserts that such stock had a fair market value of $200,000 in March of 1937. In computing its invested capital on its excess profits tax return for 1943 and for 1944, the petitioner included as borrowed capital the $535,000 in bonds which it had issued in 1937. The Commissioner determined that in computing borrowed capital for those years, petitioner was not entitled to include the $535,000 bonds at face value; that the

fair market value of the property for which bonds had been exchanged in 1937 was $350,000, being the price at which it had previously been sold at foreclosure, and that consequently only that amount could be included in borrowed capital.

The Tax Court held that the petitioner's unadjusted basis for the warehouse property was that of its transferor: to-wit, the fair market value at the time of acquisition of the property by the petitioner; and that such value was determined to be $450,000, of which $300,000 was allocable to the building and $150,000 to the land. It was held further that, in computing invested capital for excess profits tax purposes, the unadjusted basis of the property must be allocated between the bonds and the stock for which it was exchanged in accordance with the fair market values of each; that, in March 1937, the fair market value of the bonds was $375,000, and that of the stock $75,000; and that such amounts are to be included in borrowed capital and equity invested capital respectively.

In its opinion, the Tax Court stated that the first issue to be decided was the sole disputed point as to the proper basis to be used in determining petitioner's depreciation deductions on its warehouse building for the calendar years 1943 and 1944, the rate of depreciation having been stipulated by the parties. It was pointed out that the parties were in agreement that the exchange of the land and the building for petitioner's bonds and stock is governed by section 112 (b) (5) of the 1939 Code and that, therefore, pursuant to section 113 (a) (8), petitioner's basis for the property is the same as that of its transferor. The Tax Court found as a fact that the fair market value of the property in March of 1937 was $450,000, of which $300,000 was allocable to the building and $150,000 to the land. This finding was based upon an analysis of the evidence in which, not only reproduction costs were considered, but the records of past earnings and the prospect of future

earnings were likewise embraced. We are unable to conclude that the Tax Court's finding was clearly erroneous. In reaching this opinion, we adhere to the principles enunciated in *Lincoln Electric Co.* v. *Commissioner*, 162 F. (2d) 379 (C. A. 6); *United States* v. *Gypsum Co.*, 333 U. S. 364, 395; *Universal Camera Corp.* v. *Labor Board*, 340 U. S. 474, 490; *E. H. Sheldon & Co.* v. *Commissioner*, 214 F. (2d) 655, 658, 659 (C. A. 6); and other cases cited by the petitioner. But, in so doing, we find no occasion to set aside the findings of the Tax Court as we have done in cases where in our opinion such decisions were clearly erroneous. *Wright-Bernet* v. *Commissioner of Internal Revenue*, 172 F. (2d) 343 (C. A. 6); and *Roth Office Equipment Co.* v. *Gallagher*, 172 F. (2d) 452 (C. A. 6).

In computing the borrowed invested capital of the petitioner for excess profits tax purposes, pursuant to section 719 of the Internal Revenue Code of 1939, the Tax Court held that the bonds of the petitioner were included at a valuation of $375,000, derived by allocation of the unadjusted basis of the warehouse property between the bonds and the stock in proportion to their determined fair market value. We think the holding was correct. The issue arose in relation to the amount of the excess profits credit for 1943 and 1944 allowable to the taxpayer based on its invested capital in accordance with sections 712 and 714 of the 1939 Internal Revenue Code. To determine such credit, invested capital means equity invested capital reflected in the corporation's stock and borrowed invested capital as reflected in the bonds and other evidences of outstanding indebtedness issued by the corporation.

We are in accord with this reasoning of the Tax Court: "Section 718 (a) (2) requires that property paid in for stock be included in equity invested capital at its unadjusted basis to the taxpayer. Pursuant to our determination of the first issue herein [depreciation deductions], petitioner's unadjusted basis for its warehouse property is

$450,000. Since both bonds and stock were issued in exchange for this property, its $450,000 value must be allocated between the bonds and stock according to the respective values of each at the time of the exchange in order to determine the amount includible in equity invested capital and in borrowed capital. *Tennessee, Alabama & Georgia Railway Co.*, 13 T. C. 486 (1949), affirmed 187 F. (2d) 826 (C. A. 6, 1951); Cf. *Walsh Holyoke Steam Boiler Works, Inc.*, 5 T. C. 814 (1945), affirmed 160 F. (2d) 185 (C. A. 1, 1947). Although the face value of the bonds alone was in excess of $450,000, it is obvious that petitioner is not entitled to claim more than this aggregate amount for the stock and bonds in computing its equity invested capital and borrowed capital. See *Southern Fertilizer & Chemical Co. v. Edwards, Adm'r.*, . . . F. Supp. . . . (M. D. Ga., 1955). The purpose of the invested capital credit is to establish a measure by which the amount of 'excess profits' can be determined, and before capital can be considered in computing the excess profits credit, it is required that the capital actually be invested as part of the working capital; that the capital be utilized for the earning of profits; and that the capital be subject to the risk of business. *Hart-Bartlett-Sturtevant Grain Co. v. Commissioner* (C. A. 8, 1950), 182 F. 2d 153, affirming 12 T. C. 760 (1949). In short, the capital must actually be 'invested' in the business. *Graves, Inc.*, 16 T. C. 1566 (1951), affirmed 202 F. (2d) 286 (C. A. 5, 1953), certiorari denied 346 U. S. 812. Clearly, the equity and borrowed capital invested in petitioner's business in March 1937, as the result of its exchange of its bonds and stock for the warehouse property, cannot be regarded as being more than the $450,000 fair market value of the property."

Finally, we are in accord with the argument of the respondent Commissioner of Internal Revenue that, in the Rule 50 computation proposed by the Commissioner pursuant to the findings of fact and opinion of the Tax Court, there is a proper adjustment of the taxpayer's interest

deduction in the computation of its 1944 excess profits net income pursuant to section 711 (a) (2) (B) of the 1939 Code. This Code provision is: "The deduction for interest shall be reduced by an amount equal to 50 percentum of so much interest as represents interest on the indebtedness included in the daily amounts of borrowed capital [determined under section 719 (a)]; * * *." The Commissioner reduced the taxpayer's interest deduction in a sum equal to fifty percent of interest paid by the petitioner on its bonds. Over the objection of the petitioner, the Tax Court adopted the computation of the Commissioner. Petitioner now argues that, by the computation, there was added to normal tax net income not only one-half of the interest paid on the $375,000 of bonds allowed as borrowed capital, but also one-half of the interest paid on the $160,000 of bonds disallowed.

As argued by the Commissioner, the Code section quoted above, which requires the adjustment to excess profits net income for interest paid on indebtedness included in borrowed capital, does not refer to the *amount* of the indebtedness, nor to percentages of interest. It merely refers to interest on the indebtedness included in borrowed capital. The petitioner's bonds were so included. Therefore, fifty percent of the interest paid thereon is properly to be entered into the adjustment required by section 711 (a) (2) (B), whether regarded as five percent of the face amount of the bonds, or as a higher percentage of the valuation of the bonds, for the purposes of borrowed invested capital computation. The plain wording of the statute requires that the amount of interest paid on the bonds must enter into the adjustment of interest deductions. The Tax Court adopted such computation.

The decision of the Tax Court is affirmed.

Judgment

(Filed October 24, 1958)

On petition to review a decision of the Tax Court of the United States.

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this court that the decision of the said Tax Court in this cause be and the same is hereby affirmed.

APPENDIX B

26 U. S. Code (Excess Profits Taxes)

Sec. 439. *Borrowed capital.*

(a) Average borrowed capital. For the purposes of this subchapter, the average borrowed capital for any taxable year shall be the aggregate of the daily borrowed capital for each day of such taxable year, divided by the number of days in such taxable year.

(b) Daily borrowed capital. For the purposes of this subchapter, the daily borrowed capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following:

(1) The amount of the outstanding indebtedness (not including interest) of the taxpayer, incurred in good faith for the purposes of the business, which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, deed of trust, bank loan agreement, or conditional sale contract. . . . [Added Jan. 3, 1951, 10:13 A.M., c. 1199, Title I, Sec. 101, 64 Stat. 1161.]

* * * * *

Sec. 711. *Excess profits net income.*

(a) Taxable years beginning after December 31, 1939. The excess profits net income for any taxable year beginning after December 31, 1939, shall be the normal-tax net income, as defined in section 13(a)(2) [I.R.C. 1939], for such year except that the following adjustments shall be made:

* * * * *

(2) Excess profits credit computed under invested capital credit. If the excess profits credit is computed under section 714, the adjustments shall be as follows:

* * * * * *

(B) Interest. The deduction for interest shall be reduced by an amount equal to 50 per centum of so much of such interest as represents interest on the indebtedness included in the daily amounts of borrowed capital (determined under section 719(a));

. . . [Added by Sec. 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974]

* * * * *

Sec. 716. *Average invested capital.*

The average invested capital for any taxable year shall be the aggregate of the daily invested capital for each day of such taxable year, divided by the number of days in such taxable year. [Added Oct. 8, 1940, 11 p.m., E. S. T., c. 757, Title II, Sec. 201, 54 Stat. 982.]

* * * * *

Sec. 719. *Borrowed invested capital.*

(a) Borrowed capital. The borrowed capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following:

(1) The amount of the outstanding indebtedness (not including interest) of the taxpayer which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust, plus, . . . [as amended by Sec. 230(b)(2) of the Revenue Act of 1942, c. 619, 56 Stat. 798.]

* * * * *

(b) Borrowed invested capital. The borrowed invested capital for any day of any taxable year shall be an amount equal to 50 per centum of the borrowed capital for such day. [Added Oct. 8, 1940, 11 p.m., E. S. T., c. 757, Title II, Sec. 201, 54 Stat. 984, amended Oct. 21, 1942, 4:30 p.m., E. W. T., c. 619, Title II, Secs. 205(c), 230(b)(2), 56 Stat. 902, 936.]

* * * * *